

***United States Court of Appeals
for the Second Circuit***

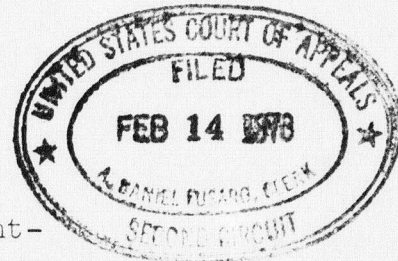


AMICUS BRIEF

77-7104

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

DOCKET NOS. 77-7104, 77-7124



DAVID E. ROLF,

Plaintiff-Appellant-
Cross-Appellee,

-against-

BLYTH EASTMAN, DILLON & CO., INC.
and MICHAEL STOTT,

Defendants-Appellees-
Cross-Appellants.

BRIEF OF MERRILL LYNCH, PIERCE, FENNER
& SMITH INCORPORATED, AS AMICUS CURIAE, IN
SUPPORT OF PETITION FOR REHEARING OR, ALTER-
NATIVELY, SUGGESTION FOR REHEARING IN BANC

BROWN, WOOD, IVEY, MITCHELL & PETTY
Attorneys for Merrill Lynch, Pierce,
Fenner & Smith Incorporated, as
Amicus Curiae
One Liberty Plaza
New York, New York 10006

OF COUNSEL:

E. Michael Bradley
James K. Manning
Duncan N. Darrow

BROWN, WOOD, IVEY, MITCHELL & PETTY

ONE LIBERTY PLAZA, NEW YORK, N. Y. 10006

212-349-7500

JOSEPH W. ARMBRUST, JR.	WALTER G. MCNEILL
GEORGE B. BOYLE	PETER J. MICHEL
E. MICHAEL BRADLEY	HENRY F. MINNEROP
WILLIAM E. CARTER	ROBERT L. MITCHELL
WILLIAM R. CARTER	RICHARD S. PETTY
RICHARD CONWAY CASEY	PAUL C. PRINGLE
PHILIP W. CLARK	JOHN A. QUISENBERRY
KENNETH T. COTE	JOHN C. RICHARDSON
THOMAS D. CREAN	A. FRANCIS ROBINSON, JR.
HOWARD G. GODWIN, JR.	RICHARD D. RUDDER
JOSEPH GUANDOLO	HOMER D. SCHAAF
ROGER J. HAWKE	NORMAN D. SLONAKER
J. COURTNEY IVEY	THOMAS R. SMITH, JR.
CHARLES J. JOHNSON, JR.	EDWARD P. TOLLEY, JR.
RALPH L. JONES	SEDGWICK A. WARD
GEORGE R. LASHNITS	KAREL WESTERLING
F. LEE LIEBOLT, JR.	HOWARD W. WHITAKER, JR.
JAMES K. MANNING	MICHAEL G. WOLFSON
JAMES B. MAY	

SAN FRANCISCO OFFICE
ALCOA BUILDING
ONE MARITIME PLAZA
SAN FRANCISCO, CALIF. 94111
TELEPHONE: 415-398-3909

TELEX: 127324
CABLE ADDRESS: BROWOODLAW

February 1, 1978

TO THE HONORABLE JUDGES OF THE SECOND CIRCUIT

On behalf of Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), we are submitting the enclosed brief and motion for leave of court to file a brief, as amicus curiae, in support of the petition for a rehearing or, alternatively, a suggestion for rehearing in banc which has been filed by defendants-appellees-cross-appellants in David E. Rolf v. Blyth Eastman, Dillon & Co., Inc. and Michael Stott (Docket Nos. 77-7104, 77-7124).

As we have noted in our papers, Merrill Lynch is one of the country's major broker-dealers, is engaged in most aspects of the securities business, including the servicing of accounts managed by independent investment advisers, and believes the issues raised by the January 3, 1978 decision of a panel of this Court in Rolf are of industry-wide importance. Additionally, we wish to advise the Court that similar issues are raised in an action in which Merrill Lynch is a defendant which is pending in the United States District Court for the District of Maryland and is entitled Lillian F. Kaufman, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al. (Civil Action No. B76-227).

Yours very truly,

E. Michael Bradley
E. Michael Bradley ✓

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Preliminary Statement

On January 3, 1978, a divided panel of this Court affirmed the District Court decision as to liability and reversed and remanded this action for a new determination of damages. The defendants-appellees-cross-appellants have submitted a petition to this Court for a rehearing or, alternatively, a suggestion for rehearing in banc with respect to the panel opinion. Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), pursuant to Rule 29 of the Federal Rules of Appellate Procedure, submits this brief, as amicus curiae, in support of that petition, which Merrill Lynch has reviewed and endorses.

ARGUMENT

The opinion of the panel majority imposed aiding and abetting liability on a registered representative and his broker-dealer employer under Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10(b)-5, for losses suffered by an investor as a result of "unsuitable" purchases and sales of securities in a discretionary account managed by an independent investment adviser.

The majority held, inter alia, that although an investor's securities account is managed exclusively by an investment adviser with written authorization to make all investment decisions, the broker executing transactions for that account still owes the customer a fiduciary duty. The majority further held that in the context of such a fiduciary relationship, the requisite scienter for aiding and abetting liability under Section 10(b) and Rule 10b-5 may be satisfied by a claimed reckless endorsement of the investment adviser's competence.

As a major securities firm with registered representatives who service accounts managed by investment advisers, Merrill Lynch has a substantial interest in a broker's legal duties with respect to such accounts. We believe that this issue, which had never been addressed by the courts until the panel's opinion, is one of industry-wide importance. Merrill Lynch respectfully submits that the majority mis-

construed and overlooked substantial legal authority.

First, the majority adopted an erroneous concept of "recklessness" and then used it as the equivalent of scienter for purposes of imposing liability under Section 10(b) and Rule 10b-5. In so doing, the majority violated fundamental principles established by the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

Second, contrary to the majority's holding, a fiduciary relationship may not be used as a premise for Rule 10b-5 liability upon a showing of something less than scienter on the broker's part. Since the breach of a fiduciary duty does not state a claim for relief under Rule 10b-5, Green v. Sante Fe Industries, Inc., 51 L. Ed. 2d 480 (1977), such a duty or even its breach cannot serve as the basis for altering the substantive elements of a Rule 10b-5 claim, specifically scienter.

Indeed, it appears that the majority has resurrected the "flexible duty" analysis of Rule 10b-5 liability. See, White v. Abrams, 495 F.2d 724, 732 (9th Cir. 1974). According to that now discredited approach, the requisite intent to defraud depends upon the relationship between the plaintiff and defendant, and the duty that that relationship entails. The Supreme Court specifically rejected such a "flexible standard of liability" in Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 191-92 n.6.

Third, the majority erred in its assumption that a fiduciary relationship in fact existed. With respect to the relationship between the defendant-stockbroker and plaintiff-customer, the majority simply asserted that "[c]learly, Stott, as Rolf's broker, owed Rolf a fiduciary duty"*.

Only one case, Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969),** was cited by the majority as authority for its finding of a fiduciary relationship. The majority's reliance is misplaced. The Second Circuit specifically found the issue of scienter irrelevant in Hanly, which arose out of an SEC administrative proceeding. 415 F.2d at 596. Moreover, Hanly was not concerned with fiduciary duty, but rather with a stockbroker's "implied warranty" to his customer that affirmative recommendations about a specific security had an adequate basis. The Court also distinguished between the rigid enforcement of this implied warranty in an administrative proceeding as opposed to a civil damage action. Id.

We submit that it is not, and never has been, the law that a broker owes a fiduciary duty per se and that there is such a duty in each and every circumstance. Whether or not such a fiduciary relationship exists will turn on the specific facts of each case. We further submit that an

* Slip Opinion at 898.

** Slip Opinion at 898.

executing broker had no such duty under the circumstances at bar. To hold otherwise is not only contrary to prior law but also places an impossible burden of inquiry on executing brokers, requiring them to intrude between the investment adviser and the customer on each and every trade, irrespective of overall investment strategy. This added burden and the potential for liability in such situations will effectively preclude brokers from routinely accepting accounts of independent investment advisers.

CONCLUSION

For the foregoing reasons, as well as those set forth in the petition of defendants-appellees-cross appellants, Merrill Lynch respectfully urges that this Court grant the petition for rehearing or, alternatively, the suggestion for rehearing in banc.

Dated: New York, New York
February 1, 1978

Respectfully submitted,

BROWN, WOOD, IVEY, MITCHELL & PETTY

By E. Michael Bradley
(A Member of the Firm)
Attorneys for Merrill Lynch, Pierce,
Fenner & Smith Incorporated as
Amicus Curiae
One Liberty Plaza
New York, New York 10006
(212) 349-7500

OF COUNSEL:

E. Michael Bradley
James K. Manning
Duncan N. Darrow